No. 305

In the Supreme Court of the United States

OCTOBER TERM, 1967

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

NEW ENGLAND ELECTRIC SYSTEM, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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CITATIONS

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The basic issue respondents tender is whether the Commission properly exercised its expertise in ruling that NEES had not established that the divestiture of its gas system would result in the "loss of substantial economies" under Section 11(b)(1)(A) of the Public Utility Holding Company Act of 1935. Respondents specifically accept (Br. 12) the major premises of our opening brief: that retention of an additional system represents "a narrow exception to the general policy of the Act" limiting registered holding companies to a single integrated system; that the holding company has the burden of affirmatively bringing itself within this exception; and that this burden is a heavy one, since the test for determining whether there will be

a "substantial" loss of economies upon divestiture is "stringent." They contend (*ibid.*), however, that the Commission must "apply its expertise specifically to analysis and prediction of the *effect* of anticipated loss on the future health and operation of the divested system" (italics in original), and that the agency failed to do so in this case. More specifically, their major contentions are (1) that the Ebasco study showed that divestiture would result in an annual loss of economies in excess of $1,000,000, and that the Commission neither had adequate grounds nor adequately explained its reasons for refusing to accept this figure (Point 1, Br. 13–24); (2) that such a loss is "substantial" in the statutory sense (Point 2, Br. 24–30); and (3) that in applying the test of "loss of substantial economies" approved by this Court when the case was previously here—"economies so important as to cause a serious impairment of [the] system" (384 U.S. at 179)—the Commission cannot give any weight to the advantages of competition without "identifying and evaluating specific benefits" by way of a "set-off against proven loss" (Point 3, Br. 30–33, quoted language at p. 32).

Although our opening brief demonstrated that the Commission's decision in this case represented a sound application of the Commission's experience and skill gained through many years of administering the statute, respondents' contentions require a somewhat fuller discussion of the agency's decision and the record upon which it was based.

I

THE COMMISSION WAS JUSTIFIED IN CONCLUDING THAT THE EBASCO REPORT DID NOT ESTABLISH THAT DIVESTITURE WOULD ENTAIL THE LOSS OF SUBSTANTIAL ECONOMIES

A. THE COMMISSION WAS QUALIFIED TO EVALUATE THE RELIABILITY OF THE EBASCO STUDY AS A BASIS FOR PREDICTING THE ADDITIONAL EXPENSES LIKELY TO BE INCURRED UPON DIVESTITURE

Basic to respondents' arguments is the apparent assumption that the Ebasco firm, which had devoted more than 4,500 man hours over a period of twelve months with the cooperation of NEES officers and employees to a forecast of the effects of severance, was so expert and was capable of such precision in forecasting the numerous business decisions that would confront the post-severance management (see our main brief, pages 19–21) that the Commission could reject the sum of the individual predictions only to the extent of demonstrable and measurable errors, such as arithmetical mistakes in adding up the individual items.

We pointed out in our main brief both the inherent uncertainties of such a forecast (pp. 19–21) and the internal inconsistencies in the Ebasco study that undermined its reliability as an accurate prediction of future cost increases (pp. 22–27). Over the years the Commission has considered a number of similar studies and predictions of holding company managements and their outside experts in determining the retainability under Clause A of other utility systems as to which a claim of "loss of substantial economies" was made; it accordingly was able to evaluate the over-

all reliability of the Ebasco study as a reasonable prediction of the additional expenses likely to result from divestiture. It would be both impractical and unnecessary to require the Commission to determine whether each of the innumerable assumed post-severance business decisions would be made and, if so, would have the consequences predicted. The Commission thus had ample basis for concluding that the defects it found in the Ebasco study "materially impair[ed] its persuasiveness and ma[de] it unacceptable" (A. 24) as an accurate forecast of additional costs upon divestiture—a conclusion reinforced by its observation of successful operation of other systems that are smaller or no larger than the NEES gas system (A. 17–18, *infra,* pp. 12–22).

Respondents argue (Br. 11, 14–15), however, that the Commission does give weight to similar forecasts and, indeed, must have relied upon the Ebasco study in this case in finding that the NEES gas companies constitute an integrated gas system. They point out that Section 2(a)(29)(B) lists, as one element in the definition of such a system, that "substantial economies may be effectuated" if the companies are "operated as a single coordinated system," and urge (Br. 16) that the Commission "had no other basis for concluding that the NEES gas companies are a single integrated system, and it conceded that point (A. 3)." There was no concession, however, of the reliability of the Ebasco report for any purpose. The staff had conceded that the NEES gas system constitutes a single integrated system and the Commission's express reliance was on that concession (A. 3). If the Com-

mission in fact relied on the Ebasco report in accepting that concession, it was only because the report showed that treating the gas companies as a single system was consistent with the economic philosophy of the Act. Each of the gas companies was relatively small; the companies operated in a compact area in a single state; and there were no overlapping service areas. In that context the evidence concerning the advantages of operating the companies under common officers and professional employees and of jointly purchasing fuel oil to produce gas for peak demands, provided a justification for keeping the gas companies together that had no counterpart in respondents' case for retaining both the gas and electric systems.

As indicated in our main brief, the Commission rejected the Ebasco estimate for purposes of applying the test of retainability under Clause A in part because it did not make out a convincing case for exception to the general policy of the Act that ordinarily holding companies would be limited to a single system—a conclusion confirmed by the inherent incredibility of the claim that a system as large as the NEES gas properties could not operate efficiently on its own. Insofar as the rejection rested upon internal inconsistencies, these appeared to suggest that, in changing the basis of the study from divestment of the eight gas companies separately to divestment as a system, the adjustment made inadequate allowance for savings from operation as a system (see our main brief, p. 22–23, and *infra*, p. 6–12).

B. THE COMMISSION WAS JUSTIFIED IN CONCLUDING THAT THE DEFECTS IN THE EBASCO STUDY MADE IT UNRELIABLE AS A BASIS FOR ESTIMATING THE INCREASED EXPENSES UPON DIVESTITURE

1. Respondents challenge (Br. 14) the statement in our main brief (pp. 22–23) that the Ebasco study had originally been prepared to show the loss of economies to each gas company, if each were to operate independently after severance, and then had been readjusted to allow for the hypothesis that the gas system would be divested as a unit. Mr. Quig, who was in charge of the Ebasco study (R. 101), testified that Ebasco's "original gas severance study was developed on the assumption that the eight gas companies would go out of the NEES system individually and be operated independently of one another" (R. 564). When NEES later decided to consider the possibility of combined gas operations separate from the electric system, the results were set forth, Quig testified, in a "Supplemental Report" (R. 563, 565). He further explained that "[s]ince an analysis of the loss of economies on a combined basis requires much of the ground work which is set forth in the study on an independent company basis, it seemed to us to make more sense to follow the independent company basis through to its conclusion and then look at the combined basis" (R. 573).[1]

[1] The letter from Ebasco to NEES transmitting the Supplemental Study and the Introduction to the Supplemental Study both confirm that it was prepared separately and that Ebasco considered "[m]uch of the work done and the data collected in the course of the [original] study" to be applicable, with appropriate adjustments, to the Supplemental Study (Respondents' Exhibit 91, R. Vol. VI, pp. 1–2).

2. Respondents seem to suggest (Br. 17–20) that two separate and insignificant criticisms form the basis for the Commission's rejection of the Ebasco conclusions. Respondents misconstrue the Commission's decision. These two factors, along with others, together provide examples of significant deficiencies in computing increased costs of customer accounting—a major component of the Ebasco estimates. The Commission noted that customer accounting alone, one aspect of treasury cost, represented 40 percent of the projected total increased cost resulting from severance of the gas properties (A. 12). If that $415,600 figure for customer accounting was substantially in error, it necessarily affected Ebasco's overall conclusion of the estimated loss of economies. The Commission noted that an identical amount was estimated for customer accounting both in the original study, which assumed separate operations of the gas companies after severance, and in the supplemental report, which purported to project the results of combined operations (R. Vol. VI p. 40) and that Ebasco had failed "adequately to explain why combined operations would not result in lesser amounts for such costs * * *" (A. 12).

3. It is not disputed that the Ebasco Supplemental Study made no adjustment to the earlier study (which assumed each gas company would be separately operated) to reflect any potential saving from centralized billing for the NEES gas system after divestment. To the Commission it appeared that unnecessary additional personnel would thus be employed for billing purposes and that respondents had given no

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satisfactory explanation why some form of combined billing procedure could not be employed advantageously (A. 12–13).

Respondents argue (Br. 17–19) that, contrary to the Commission's findings, the Ebasco experts considered and for sound reasons rejected centralized billing and that, in any event, customers' billing was not a "significant part of a broader function called customer accounting * * *" (Br. 18). But Johnson, the witness who was responsible for the treasury and accounting elements of the Ebasco report (R. 522), admitted that no study of the matter had been made (R. 898, 901, 908), although he acknowledged that in the utilities industry "centralized billing is, perhaps, predominant, more than predominant" (R. 911). And while he claimed competence to testify that there would be no savings, he conceded that without further study he would not so advise the severed gas system as a hypothetical future client.[2]

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[2] "XQ. Mr. Johnson, assuming that the combined companies were separated from the NEES System, and were to request—were to ask, rather, for your opinion, as to whether or not they should install a centralized billing arrangement, what would your answer be?

"A. I would not give them a definitive answer until I made a study, in sufficient depth to give them a sound recommendation.

"XQ. How can you give us an opinion then?

"A. That is a different case. Here, I say, in my judgment, these decentralized billing centers will not result in any substantial increased cost, and you will not make any substantial savings by doing it on a centralized basis.

"XQ. Is that the answer you would give the Management?

"A. I told you I would make a study in sufficient depth." (R. 913)

Respondents' quotation from the court below as to the extent of the savings from centralized billing, as compared to overall costs (Br. 18–19), shows that the court misapprehended the purpose and significance of the Commission's conclusions with respect to centralized billing. The Commission did no more than to conclude from Ebasco's failure to consider this matter in sufficient depth and from other unexplained anomalies in the report that the deficiencies "substantially impair the credibility and preclude the acceptance of * * * [Ebasco's] estimate of a $472,100 increase in treasury and accounting costs and, in turn, of its over-all estimate of increased costs (of which that figure is a material part) * * *" (A. 14). Thus, even if the dollar amount of Ebasco's prediction of increased billing costs is itself not deemed sizable, as respondents suggest (Br. 19), the analytical error it involves disclosed a fundamental weakness in the methodology of the study and, in conjunction with the other deficiencies noted by the Commission, justified the latter in rejecting the study.

4. Ebasco's computations showed the difference between the expense per books and the expenses it estimated *pro forma*. These differences, which purported to reflect the increases in expenses resulting from severance are valid, of course, only if both the book figures and the manner of deriving the *pro forma* estimates are correct. To test these figures, the Commission selected two localities—Lynn and Northampton—in which both gas and electric services were provided and certain elements of treasury and accounting work were jointly performed by the two subsidiaries.

With respect to Northampton, the Commission found that an allocation had been made by NEES between its gas and electric subsidiaries which attributed a significantly greater share of the joint customer accounting expense, computed on a per-customer basis, to the electric company (A. 13). With respect to the broader category of "treasury and accounting," the Commission found a similar anomaly in the allocation of expenses between the gas and electric companies located in Lynn (A. 14). In the absence of an adequate explanation, as the Commission observed, these facts cast doubt upon the estimates of increases both in customer accounting and in the larger category of "treasury and accounting." Since the allocation of expenses to the gas operations apparently was understated in each case, an overstatement of post-severance projected increases in expenses predicated upon those figures would necessarily result. Respondents suggest (Br. 20) that the Commission comparisons are "meaningless" and that an explanation exists for these apparent inconsistencies; but the Commission was entitled to rely upon what the record showed, and respondents tacitly admit that they never attempted to explain this anomaly in the figures upon which the Ebasco study was predicated.[3]

Respondents also assert that, with respect to its analysis of joint accounting in Northampton, the

[3] Respondents state that their witness "was cut off on this point by counsel for the Commission's staff" and that counsel never thereafter returned to the subject (Br. 20), but this omission to continue a particular line of cross-examination in no way remedies respondents' failure to sustain its burden of proof.

Commission erred in its use of *pro forma* figures on an independent rather than on a combined gas company basis (Br. 20). With respect to Northampton, however, the Commission focused its attention specifically on the allocation of customer accounting expenses, and the record shows that *pro forma* estimates for customer accounting at Northampton were identical—as indeed was the $415,600 projected customer accounting cost for all gas companies combined—whether projected on an independent or a combined basis. (Compare R. Vol. VI p. 32 with R. Vol. IV p. 620; cf. R. Vol. VI p. 40.)[4]

5. Respondents dispute (Br. 17 n. 8) a statement in our brief quoting from the opinion of the court

[4] In the pages of the record cited by respondents (R. Vol. IV p. 626), certain adjustments had been made to the customer accounting estimates on an independent basis. Since those adjustments would be equally appropriate whether separate or combined operation was assumed, the Commission was entitled to employ the adjusted amount for purposes of its analysis (See A. 13).

The Commission's observations (A. 13–14) concerning the allocations made on the books with respect to the customer accounting expenses for Northampton and the treasury and accounting expenses for Lynn are unaffected by the fact that the Commission, in pointing to the unaccountably greater percentage increase in the treasury and accounting expenses projected for the gas companies than for the electric companies, referred to the *pro forma* figures on an independent, rather than on a combined, basis; in either case the prima facie inappropriateness of the per book figures was clearly demonstrated. Furthermore, whether the combined or independent *pro forma* projections are employed for those companies, a substantially greater percentage increase is attributed by the Ebasco report to the gas companies than to the electric companies in the significant item of treasury and accounting expense, and the existence of any such disparity tends to support the Commission's conclusions.

below that the Commission found suspect "the estimated additional salaries and/or positions for the top executive staff" of the post-severance gas system; they contend that there is no support for that statement in the Commission's findings and opinion. The Commission's views of this point are developed in its review of the details of the proposed salary costs and comparions with existing positions and salaries of the gas division, which indicated that persons holding comparable responsibilities to present officials would receive substantially larger compensation (A. 15 n. 19).

C. THE UNRELIABILITY OF THE EBASCO CONCLUSION IS CONFIRMED BY THE FACT THAT INDEPENDENT MASSACHUSETTS GAS COMPANIES COMPARABLE TO THE NEES GAS SYSTEM WERE ABLE TO OPERATE SUCESSFULLY.

In addition to the internal inconsistencies and flaws that made the Ebasco report unreliable as an accurate prediction of the additional expenses likely to result from divestiture, there was another fact that raised serious doubt as to its soundness. Taking the Ebasco figure of $1,098,600 loss of economies, without any allowance for inherent uncertainties or for offsetting benefits of competition, the court below derived a return on rate base for the severed NEES gas system of only 4.1 percent (A. 57–58).[5] Although the claimed

[5] The Commission's staff did not have convenient access to rate-of-return figures for the NEES subsidiaries and the only sense in which they "adduced evidence" was by questioning respondents' witnesses. Apparently the court below was referring to the figures on respondents' Exhibit 114 (R. 1431), which was introduced at the request of the staff. This exhibit showed an aggregate rate base for the year 1959 of $47,723,162 and "net

economies were attributable primarily to the separation of gas and electric properties serving common customers, there was no attempt by NEES to show from actual experience that any sizable independent gas company in the area was unable to operate efficiently and earn a fair return on its rate base. On the contrary, the record showed that seven comparable gas companies in Massachusetts not operating under common control with electric companies serving the same area were earning approximately 6 percent on their rate base (*infra,* pp. 18–19).

The fact of such successful operation of these other companies further confirmed the Commission's conclusion that the Ebasco study seriously overstated the additional expenses that would be incurred on divestiture. For if other comparable Massachusetts gas companies could operate successfully and produce a fair rate of return without the alleged benefits resulting from the combination of electric and gas properties

operating income" of \$3,050,988, from which respondents computed a 6.4 percent rate of return. Deducting the \$1,098,600 of forecast additional expenses from the \$3,050,988 figure gives \$1,952,388, which is approximately 4.1 percent of \$47,723,162. But if NEES were to incur such additional expenses, there would be income tax deductions of roughly 50 percent, so that the actual reduction in the projected rate of return for the NEES gas system would be only half as much as assumed by the court below. The rate of return would be about 5.2 percent.

This error might also account for the concern of the court below as to the possibility of "new equity financing" (A. 59), despite the testimony of Mr. Hanson, the chief financing and accounting officer of the NEES system (R. 333), that he "would expect" that the severed gas system would be able to arrange financing "on a sound and economic basis," although probably its equity financing would be more costly than at present (R. 1159–1160).

serving largely the same customers, it is difficult to see why the NEES gas system could not also do so.

Indeed, the experience of the independent companies suggests (1) that the Ebasco report overstated the increased expenses; (2) that the severed NEES gas system would not be operated as efficiently as the independent gas companies; or (3) that the advantages of freeing a gas system from common control with a competing electric system, although not reducible to figures, are more significant than either NEES or the court of appeals recognizes. But whichever of these hypotheses may be correct, NEES plainly had not sustained its "heavy burden" (see Resp. Br. 12) of showing that divestiture of its gas system would entail the "loss of substantial economies" under Clause A.[6]

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[6] Respondents' argument and the reasoning of the court below assumed that there is a sharp differentiation between the issue of the reliability of the Ebasco forecast and the issue of the substantiality of the loss of economies if such reliability be accepted. While the Commission's opinion dealt sucessively with these two elements of NEES's case, the ultimate issue was whether NEES had met its burden of showing a loss of substantial economies within the meaning of Cause A. The Commission referred to the successful operation of the independent gas companies in that portion of its opinion dealing with the failure of NEES to establish that any loss of economies "would be substantial", even accepting the Ebasco forecast. We have pointed out (Main Br. pp. 27–28) that implicit in that treatment is recognition of inherent uncertainties of such a forecast. Once this inherent uncertainty is recognized, it becomes apparent that the experience of the independent companies is pertinent to both aspects of the case as well as to the overall conclusion of the Commission that NEES had not satisfied its burden under Clause A.

D. THE COMMISSION PROPERLY TREATED THE SEVEN OTHER GAS COMPANIES IN MASSACHUSETTS AS COMPARABLE TO THE NEES GAS SYSTEM

The inferences that the Commission drew from the apparently successful operation of other Massachusetts gas companies must be evaluated in relation to the nature of the loss of economies claimed by NEES. NEES's president, William Webster, testified: "The supplemental study establishes that almost 80 percent of the total loss of economies stems from the separation of gas from electric" (R. 755–756). Webster was referring, of course, to the fact that the NEES gas and electric companies have overlapping service areas and common customers. About 78 percent of the NEES system's gas customers were also served by its electric subsidiaries (A. 4).[7] The Commission's finding that respondents here attack was that other "independent" Massachusetts gas utility companies, although subject to the same competitive conditions applicable to the post-severance NEES gas system, "nevertheless have been able to conduct their operations and, apparently, earn a fair return without the alleged advantages of common control with electric utilities by a holding company." (A. 17.) Respondents argue (Br. 28) that the "Commission assumed with

[7] In our main brief (p. 22 and n. 7), we used the figure of "more than 70 percent" in pointing out the anomaly of respondents' attribution of approximately $1,100,000 of predicted losses to separation of the gas and electric systems and only approximately $400,000 to the further fragmentation of the gas system into eight smaller units. Regardless of figures, it is clear that the alleged advantages of combining electric and gas service in the same area are the heart of NEES's case for loss of economies from severance.

no evidence, that the other companies in Massachusetts used for comparison (i) were independent, (ii) were subject to the same competitive conditions, (iii) were able to compete effectively with oil and (iv) were capable of economical operation" and that there is "clear and explicit evidence controverting each" of these assumptions.

Respondent's Exhibit 117 (R. 1436, 1227), offered at the request of the Commission's staff, is the basic document upon which the Commission based its conclusion that other comparable Massachusetts gas companies had been able to operate successfully without being under common control with an electric company serving the same customers. But in view of the respondents' attack on the validity of the Commission's comparison, it is necessary to set forth in some detail the background against which this exhibit was introduced.

The Chairman of the Massachusetts Department of Public Utilities had testified that an unnamed Massachusetts gas company had gone bankrupt. This statement, to which respondents twice refer (Br. 28, 35), was made in the following context (R. 591):

> Q. But it is true, is it not, Mr. Lang, that there are gas companies which are operating successfully in your area without being part of a system such as NEES?
>
> A. Of course that is true—although the word "successful" is a relative matter. The point is that each of these gas companies has its own particular background and history, its own problems as to franchise areas, expenses, and its own standards as to service.

> Taking into consideration the problems and situations in which they have developed over the years, these eight gas companies today generally operate on a sound efficient basis under our supervision and regulation. But, we do have ecenomic [sic] problems with some gas companies, as might be expected in this area of intense competition with which the gas companies are faced.
>
> One of our gas companies in the Connecticut Valley has recently been through bankruptcy. It has since been converted to natural gas and taken over by another gas company in the western part of the Commonwealth.
>
> In other cases it is obvious that some of the independent companies suffer from not having the economies of being part of a system such as the NEES system.

The following day Webster, the president of NEES, attempted to treat this reference to the misfortune of an apparently small manufactured-gas company, the identity of which was never revealed, into a significant indication of prospective difficulties for the large NEES natural gas system following divestment. His pertinent testimony is as follows (R. 762):

> XQ. Well, now, how are these independent non-affiliated gas companies able to operate apparently profitably and efficiently, without the advantage of a holding company?
>
> A. Well, first, some of them have gone bankrupt, as the Chairman of the Massachusetts Department of Public Utilities testified yesterday. Others are—it wouldn't be fair to say just a jump ahead of the sheriff, but they are unable to give the service we think we give,

and they are probably closer to the line. They face a more serious competitive position than ours do operated as we are now handling it.

XQ. Are any of the larger gas companies, independent gas companies, in Massachusetts, experiencing difficulty with rendering adequate service, and financing themselves, that you know of?

A. I am not in a position to answer that.

In view of Webster's lack of knowledge as to how the sizable independent Massachusetts companies were faring, NEES was requested to, and did, supply from the public record of reports to the Massachusetts Department of Utilities figures as to the return on rate base for the seven companies listed on respondents' Exhibit No. 117.[8] The following table combines some of the information on that exhibit and on respondents' Exhibit 90 to show, for the years 1958 and 1959 the rates of return on rate base and

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[8] Respondents criticize the selection of these seven companies (Br. 28–29, n. 17). As they note, one of the Ebasco witnesses, for a different comparative purpose, had referred to twelve non-affiliated Massachusetts companies. His worksheet became respondents' Exhibit 90, which purported to include every gas company in Massachusetts, including gas departments of combined gas and electric companies, with more than 5,000 gas meters (R. 557–562, 1365). The staff eliminated five of these twelve companies as not comparable to the severed NEES gas system—three of them because they were combined gas and electric companies; a fourth, Boston Gas Company, because it had not, as of the year in question, converted to natural gas; and, finally, Buzzards Bay Gas Company (which barely exceeded the minimum of 5,000 meters used by the NEES expert as a test of comparability) because of its seasonal business (notes to Division's Exs. 4A—4D, R.1449–1452).

for the year 1958 the number of customers served by each of the seven companies:

	No. of Customers, 12/31/58	Rate of Return on Rate Base	
		1958	*1959*
Berkshire Gas	24,963	6.0%	5.2%
Brockton-Taunton Gas	51,955	6.2	6.1
Fall River Gas	34,576	6.4	6.2
Haverhill Gas	19,786	6.4	6.8
Lowell Gas	29,206	8.5	7.9
Springfield Gas	66,179	6.5	6.4
Worcester Gas	77,940	5.4	4.5
Average		6.3%	5.9%

Although respondents contend (Br. 29, n. 17) that only three of the seven companies on Exhibit 117 are "independent," they neither explain what they mean thereby nor specify the companies to which they refer. The Commission used the term as meaning companies not under common control with an electric company serving the same area—a sound basis for comparing the performance of the other gas companies in view of the fact that nearly 80 percent of the alleged increased expenses upon divestiture projected in the Ebasco study resulted from the separation of the overlapping NEES gas and electric companies.

Each of the gas companies shown on the exhibit is much smaller than the combined NEES system with its 235,765 customers in 1958 (Respondents' Exhibit 90, R. 1365). Their rates of return on rate base ranged from 5.4 to 8.5 percent in 1958 and 4.5 to 7.9 percent in 1959. Three of the companies—Berkshire Gas, Fall River Gas, and Haverhill Gas—apparently are concededly independent in an absolute sense, *i.e.,* they are

not under joint control with any other gas or electric company.[9] Brockton-Taunton Gas and Springfield Gas, serving, respectively, 51,955 and 66,179 customers, in the aggregate approximately half the number served by the NEES gas system, are affiliated with each other in the sense that they appear to be under common control but there is no affiliation with companies which supply electricity in their service areas. Worcester Gas Company is part of an exempt intrastate holding company system that has both gas and electric companies in Massachusetts, but it has no affiliation with a company furnishing electricity in the Worcester service area, where electricity is furnished by a NEES subsidiary (see respondents' Exhibit 3, R. 1297).[10] Lowell Gas Company apparently is under common control with Buzzard's Bay Gas Company, a small gas company[11] whose business is largely seasonal, but has no affiliation with any electric company.

Thus, each of the other seven gas companies considered by the Commission was comparable to the post-

[9] The primary authority respondents cite for their claim that the seven companies are not "independent" is Moody's *Public Utility Manual* (1959). The material in the text dealing with the affiliation of those compaines is derived from that source. In the court of appeals, where respondents made a simialr contention, they apparently conceded that Berkshire, Fall River and Haverhill were "independent" under any standard.

[10] These two companies also are under common control with Fitchburg Gas and Electric Light Company, and other companies outside Massachusetts. Adding the 10,967 customers from the gas department of the Fitchburg Company to those of Brockton-Taunton Gas Company and Springfield Gas Company still gives only 129,101 customers compared to 235,765 for the NEES gas system.

[11] Buzzards Bay served only 5,454 customers, compared to 29,206 served by Lowell, Respondents' Ex. 90, R. 1365.

severance independent NEES gas system since, in addition to operating in Massachusetts and being smaller than the NEES gas system, none was affiliated with an electric company serving the same customers. The Commission also properly rejected the further argument that these companies are not comparable because the NEES gas companies had peculiar handicaps in the service areas where they operate,[12] ruling that respondents had "failed to show that, because of these factors, the impact of severance would be such that the combined NEES gas operations * * * would be unable to compete effectively with oil, even though the nonaffiliated companies are able to do so" (A. 17–18, footnote omitted).

To be sure, the record contains no detailed study of the operations of these seven companies. But that fact does not vitiate the Commission's comparison between them and the divested NEES gas system. For, as noted, these companies were significantly smaller than the NEES system,[13] and *prima facie* their ability to operate successfully without being under common control with an electric company serving the same area was shown by Respondent's Exhibit 117 and confirmed

[12] These handicaps were the relatively slower economic growth, population increase and suburban development increase for the NEES gas franchise areas compared to those of the independent gas companies.

[13] The New England Gas and Electric Association, an intrastate holding company of which Worcester Gas Company is a part, had slightly higher consolidated gas revenues than the NEES gas system ($23,358,000 as against $23,276,000) but significantly fewer gas customers (approximately 171,000 as compared to 235,765) (Respondents' Exhibits 57 (R. 1310); 90 (R. 1365)).

by the admission of NEES' president that he had no information to the contrary (*supra*, p. 18).

E. IN HOLDING THAT THE ADDITIONAL EXPENSES OF $1,098,600 ESTIMATED BY THE EBASCO REPORT WOULD NOT CONSTITUTE A LOSS OF SUBSTANTIAL ECONOMIES, THE COMMISSION PROPERLY CONSIDERED ITS DECISIONS IN PRIOR DIVESTMENT CASES.

In ruling that, even accepting *arguendo* the Ebasco estimate of a $1,098,600 loss of economies upon divestiture, such loss would not be substantial, the Commission examined the impact of such increased expenses upon the NEES gas system, as measured by ratios it deemed significant; [14] and pointed out that such ratios "are lower or not significantly higher than corresponding ratios of gas systems whose divestment we have required on the ground that the estimated loss of economies was not substantial within the meaning of Clause A" (A. 16).[15] It also noted (A. 19–21) that in such prior cases it had recognized that there were offsetting advantages resulting from the termination of joint control of electric and gas systems serving the same locality, which must be considered in determining the substantiality of the claimed losses of economies.

Respondents challenge (Br. 24–27) this comparison with the prior divestments on two grounds: (1) that it is irrelevant, since it allegedly tells nothing about

[14] The ratios were between the additional estimated expenses of the NEES gas system and its operating revenues, operating revenue deductions and gross and net income before federal taxes.

[15] Attached to its opinion is a table (A. 28) comparing the estimated NEES loss of economies "with the estimated losses in the [seven] prior cases where similar computations were made, in all of which we ordered divestment of the additional system" (A. 16, n. 22).

what the effect of the additional $1,098,600 expenses would be upon the ability of the NEES system to operate successfully; and (2) that it is inaccurate, since in five of the seven cases the Commission's divestment orders "were based not on a finding that the claimed loss of economies was not substantial, but on the fact that the Commission had not believed the estimates or that the estimates failed to show the amount of lost economies" (Br. 27).[16] Neither contention is valid.

1. Of course, the basic question before the Commission was what would be the probable effect of the additional expenses upon the ability of the NEES gas system to operate successfully, *i.e.,* would the lost economies be "so important as to cause a serious impairment of that system" (384 U.S. at 179). But in answering that question the Commission was not required to limit its inquiry solely to the NEES system; the fact that comparable increases in additional expenses had not been deemed "substantial" in other divestment cases provided considerable support for the Commission's conclusion that they were not substantial for NEES, either. In applying a legal standard that is essentially relative rather than absolute—such as whether an alleged loss of economies would be "substantial"—its application in other situations is certainly a useful guide to its content.

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[16] The Commission also relied on its prior decisions to show that the NEES gas system was larger than any other it previously had ordered divested (A. 18, n. 24). Respondents do not challenge the use of the comparison for that purpose.

2. In the appendix we discuss in some detail the five prior Commission cases with respect to which the respondents accuse the Commission of incorrectly stating the amount of additional expenses it deemed not substantial. In three of those cases the Commission accepted *arguendo* the claimed loss of economies (with certain adjustments the Commission took account of in the present case), but pointed out (as it did in the present case) that they must be evaluated in light of the offsetting benefits resulting from divestiture before their substantiality could be determined. In another of the cases respondents do not describe accurately the Commission's opinion. In the fifth case, the claim is that the figures relied on by the Commission were for the year after it rendered its decision; those figures, however, were taken from a petition for reconsideration which, the Commission held, provided no basis for disturbing its prior ruling that no loss of substantial economies had been shown.

In short, the figures upon which the Commission based its comparison between the impact of divestiture on the NEES gas system and upon the other gas systems held not retainable were accurate, and provided a proper basis for making the comparison.

II

IN APPLYING SECTION 11(B)(1)(A), THE COMMISSION PROPERLY GAVE SIGNIFICANT WEIGHT TO THE COUNTERVAILING BENEFITS OF COMPETITION

Respondents' arguments on this point are little more than a paraphrase of the view of the court below that the intangible benefits of competition result-

ing from the termination of common control of electric and gas properties are to be considered only for the purpose of adopting a "stringent" standard of retainability, but not at all in applying that standard. But if, as this Court previously held (384 U.S. at 182–185), such offsetting benefits are an appropriate factor in determining the meaning of "loss of substantial economies," they also may be considered by the Commission in applying that concept. For only in this way can this element become a truly meaningful part of the statutory standard.

Indeed, this Court appears to have specifically so recognized, since it pointed out that the determination whether "gains to competition * * * might well offset the estimated loss in economies of operation resulting from a separation of the gas properties from the utility system * * * is a matter for Commission *expertise* on the total competitive situation * * *" (pp. 184–185, footnote omitted). As pointed out in our main brief, and as this Court recognized,[17] such competitive advantages cannot be forecast with precision. The court of appeals' view that such offsetting benefits may be considered in determining whether a projected loss of economies is "substantial" only if "some definable particularized benefit will accrue from divestment" (A. 61) would, as a practical matter, deprive this factor of the significance this Court recognized Congress intended it to have.

The instant case is a particularly strong one for giving weight to the advantages of competition in

[17] The Court stated (p. 184): "Competitive advantages to be gained by a separation are difficult to forecast."

applying the standard of Clause (A). As noted above (p. 15), between 70 and 80 percent of the claimed loss of economies from severance were attributed by respondents to the alleged advantages of common control of gas and electric systems with overlapping service areas. Moreover, other comparable Massachusetts gas companies not subject to such common control generally earned a substantially higher return than that projected for the independent NEES gas system (*supra*, pp. 12, 19). The Commission was fully justified in rejecting respondents' contention that "a management solely interested in and devoted to the gas operations would not be able to advance them more effectively" (A. 21).

Respondents contend (Br. 32) that permitting the Commission thus to consider the intangible benefits of competition would immunize from judicial review every Commission determination that a loss of substantial economies had not been shown. The argument is that the agency always could rely on this factor as outweighing any demonstrated losses, no matter how large they might be. But such a hypothetical situation is a far cry from this case. For here, as we have shown, respondents have not established any losses that are "substantial" in the statutory sense; and to the extent that the case on this issue may be closer than we have argued, the offsetting competitive benefits were more than sufficient to tip the scales against retainability of the gas system.

III

THERE IS NO OCCASION TO REMAND THE CASE TO THE COMMISSION

The arguments presented in our main brief and in this reply brief demonstrate that the Commission was justified in ordering divestiture of the NEES gas system because respondents failed to carry their burden of showing that such divestiture would entail the "loss of substantial economies." To recapitulate: the Commission properly (1) evaluated the claimed loss of economies from severance in the light of the congressional purpose to create a narrow exception in Clause A, for which it was expected that only small systems would qualify;[18] (2) weighed the offsetting advantages of competition in considering the claim that gas and electric companies serving the same area had certain advantages that would be lost upon severance; and (3) rejected a prophesy of loss of economies which is inconsistent with the actual experience of every sizable independent gas system in Massachusetts that operates on natural gas.

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[18] Respondents argue (Br. 8) that in adverting to this expectation we are attempting "to reopen under Clause (A) the size requirement contained in Clause C (Br. 6, 31–33), as to which the Commission had specifically found that the requirement is satisfied (A. 7)." But the two clauses relate to different issues. Clause C requires the Commission to find that "[t]he continued combination of [of the principal and additional systems] * * * is not so large * * * as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation." It deals with the size of the two systems together, and the Commission found that the continued combination of the

There is no conflict in the expert testimony or disagreement among expert witnesses; the issue is whether the Commission had a reasonable basis for concluding that this expert evidence did not prove what it purported to demonstrate. This Court can decide that question, we believe, without further elucidation by the Commission or extensive analysis of the lengthy record. It should therefore reverse the judgment of the court of appeals and remand with instructions to that court to affirm the order of the Commission.

Respectfully submitted.

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NEES electric and gas properties would satisfy that standard. Clause A, on the other hand, deals with the loss of economies by the additional system, and in applying that Clause the fact that the additional system is large is a significant factor. See our Main brief, pp. 31–33.

APPENDIX

We discuss below the five precedents cited by the Commission, the use of which the respondents criticize in the appendix to their brief (Br. B-1–B-3). Respondents concede (Br. B-3–B-5) that the Commission properly relied upon the figures relating to the gas properties ordered divested in *Philadelphia Company,* 28 S.E.C. 35 (1948), affirmed, 177 F. 2d 720 (C.A.D.C.), and of the electric properties of Northern Pennsylvania Power Company ordered divested in *General Public Utilities Corporation,* 32 S.E.C. 807 (1951).

1. Respondents correctly point out (Br. B-2) that in ordering divestment of the gas properties of Virginia Electric and Power Company in *Engineers Public Service Co.,* 12 S.E.C. 41, 55–61, the Commission held that the company's estimate of $71,500 loss of economies was "excessive" (12 S.E.C. at 59) and that "the record, if given its most liberal interpretation, would not sustain a finding of more than one-half the claimed increased *expenses*" (p. 60, emphasis is original, footnote omitted). But the Commission "further conclude[d] that the loss of *economies* would in fact be less than *such* increased *expenses* (emphasis added, footnote omitted) (*ibid.*). The reason for that conclusion, however, was not that there were further errors in calculating the amount of increased expenses, but because (*id.,* pp. 57–58)

> * * * Congress did not speak in terms of increased *expenses.* It authorized the retention of additional systems if they could not be operated independently without the loss of substantial *economies.* And in measuring the loss of *econ-*

> *omies* accompanying the severance of a combination of two utility systems it is particularly important to consider the beneficial effects of independent ownership upon the efficient operation of each system. [Emphasis in original.]

The Commission pointed out (pp. 57–58) that it was "particularly important to consider the beneficial effects of independent ownership upon the efficient operation of each system."

Thus, the Commission there accepted *arguendo* one-half of the claimed increased expenses—$35,750—for the purpose of evaluating the substantiality of the loss of economies, but concluded that, taking into account the offsetting benefits of divestiture, the lost economies would not be substantial. In the present case the Commission used the same figure it had accepted *arguendo* in *Engineers*—$35,750—for comparing the ratios in the two cases. The use of that figure plainly was proper.

2. In *Engineers Public Service* Co., *supra,* the Commission also ordered the divestiture of the gas system of Gulf States Utilities Co. 12 S.E.C. 78–81. There, too, the Commission, although stating that the estimated additional expenses were "in several respects overstated," ruled that "the total of these increased expenses to the gas system, stated to be $42,024, does not constitute lost economies arising from the independent operation of the gas system, since it ignores compensating factors" (p. 80). The Commission pointed out (p. 81) that it must "consider a possible failure to take advantage of all available economies in the gas operation," and noted that "competing gas and electric services under a single management may result in the suppression of one service in favor of the other."

3. In *North American Co.,* 18 S.E.C. 611 (1945), the Commission ordered the divestiture of St. Louis

County Gas Company. The Commission first reduced to $160,900 the holding company's estimate of additional expenses of $182,900, because of flaws in its calculation (pp. 614–615). It then ruled (p. 615) that "[t]o accept these estimates without further inquiry would be to distort the Act. * * * We are asked to permit electric and gas utility companies serving the same territory to be held together. The businesses, in many aspects of their operations, are competitors. It is the inevitable tendency of the joint control to favor that business in which it is most interested and which is most profitable. * * * Ultimately, the issue we must resolve is whether experience will bring about the increased costs claimed by respondents *without offsetting benefits*" (pp. 615, 617, emphasis added). Here, too, as in the two divestments ordered in *Engineers,* the Commission accepted *arguendo* the adjusted estimate of additional expenses, but found that it was not a proper measure of loss of economies because it failed to consider "offsetting benefits." Once again, this was the same situation as in the present case, and the Commission was justified in relying upon the comparison with the ratios in the *North American* case.

4. In the present case the Commission stated (A. 16, n. 22) that it had considered only certain of the ratios of the gas properties of Jersey Central Power and Light Co., ordered divested in *General Public Utilities Corp.,* 32 S.E.C. 807 (1951). The Commission in that case "accepted solely for the purpose of analysis, the amount of $229,398" additional expenses claimed by the company (p. 836), and used that figure in deriving the two ratios upon which the Commission relied in the present case (p. 837). The Commission held (pp. 836–837), however, that because the study did not reflect the impending introduction of natural gas throughout the company, it did not provide an ade-

quate basis for formulating the other ratios upon which the Commission had relied in previous cases in evaluating the substantiality of the claimed losses of economies. That the Commission did accept arguendo the company's estimate of $229,398 is further shown by the comparison the Commission made between ratios based on that figure and the ratios in the Virginia, Gulf States, St. Louis County Gas and Philadelphia Gas cases, *supra* (pp. 829, 836–837). Indeed, it utilized the same figures and ratios for those companies which it used in the present case. 32 S.E.C. 829.

5. In 1953 the Commission directed the divestment of the gas properties of Louisiana Power and Light Company in *Middle South Utilities, Inc.,* 35 S.E.C. 1. In rejecting the claim that such divestiture would entail the loss of substantial economies, the Commission pointed out (p. 12): "No study of any kind was introduced to show what the expense of the gas properties would be if they were to be operated as a single unit." It held (p. 13) that it could not "find that the mere statement by the witness for the company that there would be a substantial increase in the expenses of the gas operations if they were separated sustains the burden set forth in the statute."

Two years later the Louisiana Public Service Commission sought to reopen the divestment proceedings and filed with the Commission an offer of proof that divestiture would increase expenses of the gas properties by $272,816.[1] In declining to reopen, the Commission stated that it had "considered the offer of proof

[1] This figure is contained in the record before this Court in the *Louisiana* case. See record No. 466, October Term 1956, p. 17. The figure was given in the staff's brief before the Commission in the present case. S.E.C. File No. 59–102, Answering Brief and Proposed Findings and Conclusions of the Division of Corporation Finance, p. 33, n. 46.

made by the Louisiana Commission," but that the offer provided "no grounds for questioning our earlier conclusion." *Middle South Utilities, Inc.,* 36 S.E.C. 383, 385 (1955), reversed 235 F. 2d 167 (C.A. 5), reversed on other grounds, 353 U.S. 368. The Commission pointed out (*ibid.*)that it previously had held that "Louisiana Power could retain its gas operations only if they were so small that they could not operate economically under separate management, and we found that it was clear that Louisiana Power's gas properties are capable of effective and economical operation as a separate entity."

The Commission thus ruled that a showing of increased expenses of $272,816 would not persuade it to change its prior decision that divestiture would not cause the loss of substantial economies. It therefore in effect held that a loss of economies of that amount was not substantial. The Commission accordingly properly relied upon that figure in comparing the ratios in the present case with those in the Louisiana case.

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